



Appeal of AlDean and Clara Washburn

The question presented by this appeal is whether certain payments received by appellants after they had become nonresidents were taxable by California.

It appears that Clara Washburn has been included as an appellant **because** she filed a joint return with her husband, **AlDean**. "Appellant" herein shall refer to **AlDean Washburn**.

Before August 1, 1976, appellants were residents of California. Appellant practiced dentistry in Ridgecrest, California through a professional dental **corporation** known as **AlDean Washburn, D.D.S., A Professional Corporation** (hereinafter "the corporation"). On August 1, **1976**, appellant sold his stock in the corporation and moved to Utah.

In connection with the sale of stock, on August 1, 1976, appellant executed a document headed "Covenant Not To Compete" in which he agreed, as an employee of the corporation:

That upon termination of employment of Employee and contingent upon the timely and total payment as hereinafter set forth and as permitted by law, Employee, covenants with Corporation that for a period of five (5) years from the date hereof, Employee will not engage in the active practice of dentistry in the geographic territory encompassed by a radius of thirty (30) miles with the center point the office of the Corporation, either on his own behalf or as a partner or as an employee.

Employee further covenants that he will not, during this period, directly or indirectly, induce any of the patients of Corporation to patronize any dentist other than the Corporation. Employee may, however, continue to treat any such patients **who desire** Employee's services outside of the area set forth in this Covenant Not To Compete.

In consideration of Employee granting the aforementioned Covenant Not To Compete, Corporation agrees to pay Employee Eighty-Yin? Thousand Three Hundred Eighty-Two And 51/100 Dollars (**\$89,382.51**), which **sum shall be paid** in equal monthly installments commencing on the first day of **August, 1976**, and continuing for a

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period of five (5) years; it is the intention of the parties hereto that the consideration for the covenant be treated as an ordinary expense for the Corporation and as ordinary income to the Employee.

After moving to Utah, beginning in January 1977 and continuing through May 1978, appellant apparently returned to Ridgecrest, California for three and one-half days in every fourteen-day period to practice dentistry in the corporation's office. Appellant states that "this gave [him] additional opportunities to help establish the new dentist in [his] old practice." While engaged in this part-time practice, appellant contends that he paid the corporation a percentage of his gross income from that practice for rental of equipment, office space, supplies, and the like.

Appellants filed a joint part-year resident/non-resident California personal income tax return for 1976 and a nonresident return for 1977. These returns apparently reflected appellant's income and deductions from his part-time practice in California subsequent to his move, but included none of the payments received pursuant to the covenant not to compete. On audit, respondent determined that the payments for the covenant were California source income and should have been included in appellants' California income. Proposed assessments were issued reflecting this adjustment. Appellants protested, the proposed assessments were affirmed, and this timely appeal followed.

Nonresidents must include income from sources within this state in their California gross income. (Rev. & Tax. Code; § 17951,) Payments received for a covenant not to compete are taxable as ordinary income and do not constitute income from the sale of either real or personal property. (Beals' Estate v. Commissioner, 82 F.2d 268, 270 (2d. Cir. 1936).) Compensation received for refraining from labor is ordinary income just as is compensation for services to be performed. (Arthur A. Ballantine, Jr., 46 T.C. 272, 276 (1966).) The source of compensation received for a covenant not to compete is the place where the promisor forfeited his right to act. (Korfund Co., 1 T.C. 1180 (1943), Rev. Rul. 74-108, 1974-1 Cum.Bull. 248; FTB LR 84, Dec. 5, 1958.)

Appellant contends that the written covenant not to compete did not reflect his agreement with the purchaser of his stock. This is obvious, he says, because he did in

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fact return to Ridgecrest periodically and engage in the practice of dentistry. He states that the actual agreement included his promise to assist the new dentist in establishing himself in the practice by speaking well of him, recommending him to the patients, furnishing pertinent patient information, and giving him every benefit of appellant's experience and good name in that community. Appellant contends that some of these affirmative duties were accomplished in Utah, where he talked to his former patients who visited him there. He also argues that the case of Miller v. McColgan, 17 Cal.2d. 432 [110 P.2d 419] (1941), is controlling here. Appellant states that his attorney and accountant both advised him that the income he received was Utah source income and he reported and paid tax on it in Utah.

It is well settled that the appellant bears the burden of showing that respondent's determination was erroneous. We find that appellant has not carried his burden of proof.

While appellant did return to the corporation's office in Ridgecrest and did practice dentistry there, this was apparently with the consent of the purchaser of his stock and not in competition with him. Appellant's part-time practice in Ridgecrest, under these conditions, does not show that the payments he received were not for his covenant not to compete. His mere unsupported assertion that there was more to the agreement than stated in the covenant is insufficient to show that such other agreement existed, much less that the parties intended that he should be compensated for something other than his covenant. (Cf. Appeal of George E. Gordon, Jr., Cal. St. Bd. of Equal., Nov. 19, 1968.) Where the parties have dealt at-arm's length, understanding the substance of an agreement, and both sign an agreement which specifies that a particular amount is to be paid for a covenant not to compete, strong proof is required to negate that declaration for tax purposes. (Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); Visador Co., ¶ 73,173 P-H Memo. T.C. (1973); Tobe C. Deutschmann, ¶ 66,229 F-H Memo. T.C. (1966).) No such strong proof has been presented here. We conclude that the payments received were compensation for a covenant not to compete.

Appellant's reliance on Miller v. McColgan, supra, is misplaced. That case applied the doctrine of mobilia sequuntur personam to assign shares of stock, which are intangible personal property, a situs in the state of their owner's residence, unless they have acquired a

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business situs elsewhere. As noted above, income from a covenant not to compete is treated as compensation for personal services, not as income from intangible personal property. Miller v. McColgan, therefore, is inapplicable to a determination of the source of income in this appeal.

Appellant's reliance on professional advice is irrelevant to **the** issue of the source of income. The fact that appellant paid tax to Utah on this same income does not affect the correct imposition of tax by California.

For the reasons stated above, we find that appellant received income from a covenant not to compete while a nonresident, that the income was from a California source, and that the income was properly taxable by California. Respondent's determination, therefore, is sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED,, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of **AlDean** and Clara Washburn against proposed assessments of additional personal income tax in the amounts of \$370.80 and \$1,269.95 for the years 1976 and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett , Chairman

Ernest J. Dronenburg, Jr. , Member

Richard Nevins , Member

_____, Member

_____, Member